Congress of the United States
Washington, DC 20515

The Honorable Jerome H. Powell
Chair
Board of Governors of the Federal Reserve
20th Street and Constitution Avenue N.W.
Washington, DC 20551

The Honorable Heath Tarbert
Chair
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

May 4, 2020

Dear Chair Powell and Chair Tarbert:

We write concerned with reports that major U.S. banks are poised to take ownership over highly leveraged oil and gas assets.[1] As a result of the novel coronavirus (COVID), demand for oil and gas has plummeted, exposing the over-reliance of the exploration and production (E&P) sector on excessive, high-yield debt. Major oil futures markets have already posted negative prices and there is significant risk they could fall further until enough supply has been cut to match the reductions in demand. Reduced asset value from falling prices coupled with lack of forward cash flow to service existing debt has already driven some of the most highly leveraged firms into Chapter 11 bankruptcy, and more will surely follow. The significant decline in prices of virtually all commodities, including agricultural crops and industrial metals, creates similar risks in other sectors. An analysis by JPMorgan Chase shows that oil and gas firms have been the leading issuer of junk bonds in ten of the past eleven years, and the outlook for the exploration and production sector will surely worsen after a slew of COVID-related bankruptcies and downgrades.[23]

All of these conditions have seemingly necessitated a transfer of ownership to existing creditors, at a rate and scale that could prove to be disruptive to credit and commodity markets. Although the Bank Holding Company Act generally prohibits commercial banks from engaging in non-financial activity unrelated to the "business of banking," it does permit financial holding companies (FHCs) to engage in commodities ownership, so long as the Federal Reserve concludes that that ownership does "not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally."[4] It is Congress' intent that the acquisition and active management of a large swath of physical commodities by financial holding companies be subject to approval by the Federal Reserve's Board of Governors. As the Federal Reserve reviews the approval the physical commodity activities by financial holding companies (FHCs), we ask that any approval be conditioned on the consideration of the following:

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[1] https://www.reuters.com/article/us-usa-banks-energy-assets-exclusive/exclusive-u-s-banks-prepare-to-seize-energy-assets-as-shale-boom-goes-bust-idUSKCN21R3JI
[2] https://www.nytimes.com/2020/03/20/business/energy-environment/coronavirus-oil-companies-debt.html
[3] https://www.cnn.com/2020/04/20/business/oil-price-crash-bankruptcy/index.html
[4] 12 U.S.C. § 1843(k)(1).

First, all physical commodities activities and investment of FHCs must, at least, comply with the 2016 "Proposed Rule Implementing Strengthened Prudential Requirements, including Risk-based Capital Requirements, for Physical Commodity Activities and Investments of Financial Holding Companies."[5] Although this rule was never finalized, it received unanimous approval from the Federal Reserve Board of Governors, including then-Governor Powell and Governor Brainard, and widespread support from the public.[6] It sets the minimum standard for physical commodity activities and investments of FHCs including a 1,250 percent risk weight for physical commodities and related assets which are not complementary activities, and a 300 percent risk weight to physical commodity holdings permissible under complementary physical commodity trading activities. It would also provide strong limits on permissible physical commodity trading by tightening the limits placed on physical commodity holdings under complementary authorities and clarify that the existing prohibitions on operating storage facilities or transportation includes directing the operations of the third-parties responsible for those services. It is critical this minimum standard be upheld in the approval of commodities ownership by any FHCs.

Second, as banks move these seized assets to their FHCs, they may obtain sufficient market power and information to materially manipulate commodity markets. The Federal Reserve must ensure that those holding companies have proper firewalls and supervision to shield information transfer, both within the holding company and from the holding company to the larger bank. Those firewalls must be accompanied by strict, well-enforced penalties to ensure that the costs of non-compliance exceed the financial gains.

The Commodity Futures Trading Commission (CFTC) must also increase monitoring of trading activity at any financial institution which holds or takes possession of these commodity assets. At the core of the CFTC's mission is a responsibility to promote fair derivatives markets and protect market participants from manipulation. The significant increase in market power and information that will come with these assets requires a corresponding increase in supervision and oversight. The farmers who depend on commodity markets to sell their crops, the manufacturers who purchase metals and other inputs in these markets, and everyone who is affected by energy prices must be protected from manipulation and able to benefit from fair, transparent markets. That is why we recommend penalties of not less than 150% of the financial gains the bank made on the use of illegal information sharing as these penalties must be significant enough to properly deter this activity from ever occurring, and not simply be the cost of doing business.

Third, energy companies typically operate at much lower debt to equity ratios than banks, in part to account for volatility in commodity markets and environmental liabilities. In order to ensure that the capital structure of FHCs does not exaggerate the broader financial system, the Federal Reserve should require that the FHCs debt to equity ratio does not increase beyond that of the held assets' previous two year debt to equity ratio average from the time since taking possession of these assets.

Fourth, energy and industrial companies often are required to post cash-collateralized reserves to cover operational and environmental risk. Holding companies must be required to: (a) maintain such reserves as were held prior to acquisition by the holding company; (b) increase those reserves to the extent they are not currently at levels required by statute, consent decree or other regulatory obligation, and; (c) ensure those reserves are not counted as equity for the purposes of the debt/equity ratio outlined above.

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[5] https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160923a1.pdf
[6] https://www.federalreserve.gov/apps/foia/ViewAllComments.aspx?doc_id=R-1547&doc_ver=1

Lastly, the Federal Reserve should ensure that counterparty risk from these holding companies is minimized.

Thank you for your attention to this matter and I look forward to your response.

Sincerely,

Sean Casten
Member of Congress

Cindy Axne
Member of Congress

Mike Levin
Member of Congress

Jared Huffman
Member of Congress

Denny Heck
Member of Congress